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SOVIET AND EASTERN EUROPE ECONOMIC PROBLEMS

INTRODUCTION

Mr. Casey and my colleagues have outlined for you the Soviet expansionist drive and Moscow's consequent involvement in many regions of the world. Paradoxically, this has occurred at a time when the Soviet Union's own domestic situation -- primarily economic -- is less than satisfactory.

Soviet economic problems are worsening to such an extent that the system is less and less able to support the Brezhnev-era goals of an expanding empire abroad, constant improvements in military strength, and economic gains and well-being at home. Since Soviet economic developments will have such an important bearing on that country's future, I shall examine this subject in greater detail.

Soviet economic growth has fallen from nearly 4 percent per year during most of the 1970s to less than 2 percent per year since 1978.

-- While the slowdown has occurred in all major sectors of the economy, the very low growth of the last three years is mainly the result of three consecutive bad grain harvests; output in 1981 was about 1/3 1/4 below plan.

-- Industrial production -- the traditional growth leader -- slowed from around 6 percent per year in the early 1970s to less than 3 percent per year since 1978.

-- The impact of the economic slowdown has been felt primarily in smaller annual increments in goods and services allocated to consumption and investment.

-- Meanwhile the annual increment to defense remained unchanged at 4 to 5 percent per year.

Some of the reasons for the economic slowdown are clear.

-- Harsh weather conditions accounted for much of the deterioration in agriculture, but mismanagement and smaller increases in fertilizer deliveries also played a role. Shortfalls in agriculture, of course, held back food processing and light industry.

-- The dominant factor, however, in the industrial slowdown has been the declining quality and quantity of cheap, easily accessible raw materials (especially fuels) in the Western USSR, and the need to develop high cost, lower quality sources in the north and east.

-- Soviet planners, meanwhile, have not adjusted well to the changed conditions in the economy. The ever-present tension in the economy increased markedly.

(1) Demand for transportation services exceeded supply.

(2) Production shortfalls in one sector reverberated through others; stagnant or declining production of basic materials such as steel, coal, and cement disrupted and in some cases halted construction activity and industrial operations.

(3) The productivity of labor and capital resources combined fell.

(4) Soviet planners became less able to develop balanced annual and five-year plans.

-- More fundamentally, the "command" economy, well-suited for the building of the economy by massive inputs of capital and labor in the early years of Soviet power, is now inadequate to the needs of an advanced industrial society. Most Western economists agree that the Soviets need to take two major steps.

(1) Decentralization of planning and management and introduction of elements of a market economy to make the economy more flexible and responsive to increasingly sophisticated and diversified demands.

(2) A reform of the incentive structure to introduce greater efficiency in the utilization of resources.

However, such reforms would threaten the party's control, violate Soviet ideological tenets, and run up against entrenched bureaucratic interests.

Consequently, though the Soviet leadership has paid lip service to reform in the past, it has not taken any serious action.

The outlook for the 1980s is not bright as some of the conditions contributing to the slowdown worsen and others take hold.

-- Whether or not oil production falls, energy output is clearly going to increase more slowly and become more expensive.

(1) The entire increment in energy production must come from Siberia where costs are high and infrastructure minimal. Thus, large new investments must be made in roads, rail lines, and pipelines -- large ticket items with heavy up-front costs and long lead times.

(2) Shifting the fuel balance toward natural gas will require a large buildup of distribution and storage facilities (i.e., more investment).

(3) Because smaller annual increments in total investment are planned for 1981-85, energy exploitation and associated infrastructure will absorb an increasing share of investment resources.

-- On top of the investment crunch, increments to the labor force -- declining since 1977 -- will continue to decline until 1986 and will not regain present levels until after 1990.

(1) With labor productivity nearly at a standstill, demand for labor -- especially skilled labor -- is likely to increase.

(2) But most of the new entrants will be from the Moslem areas of the USSR where few of the Soviet industries are located.

Moscow cannot look -- as it has in the past few years -- to the foreign sector for much relief.

-- The USSR was hit in 1981 by a soaring agricultural import bill, soft oil prices in the West, and to disruptions in Polish trade. As a result, the trade deficit more than doubled to about $6 billion.

-- The USSR's hard currency problem is almost certain to worsen in the coming years.

(1) The only large new source of hard currency earnings on the horizon is the Yamal gas pipeline which is not expected to go into full operation until 1986. Moscow is banking on these gas exports in the face of its own declining oil export capacity and the uncertain world oil market.

(2) Soviet current arms sales are very large, but no new major details are currently in negotiation.

(3) Although gold sales can be stepped up, Moscow must be careful not to spoil the market.

(4) The prospects for stagnation or decline in Soviet hard currency earnings indicate that Moscow will be unable to increase its hard currency imports unless the West provides more credits and Moscow accepts a larger hard currency debt.

As the Soviets look at their East European empire, they cannot be sanguine about the economic prospects of those countries either. The COMECON countries (excluding the USSR) have an aggregate hard currency debt of over close ~~to $70~~ 68 billion and are all faced with economic stagnation.

In sum, then, it is most likely that economic problems will force tough decisions on the USSR and other East European countries. The policy debates surrounding these decisions will probably become intertwined with the succession struggles which will probably occur in a number of these countries. The looming Soviet succession has been widely discussed. What is sometimes overlooked is that the leaders of Bulgaria, Czechoslovakia, Hungary, and East Germany are also around 70. The death of these leaders, particularly if this occurs close together, will introduce additional uncertainties into an already complicated situation. The Soviet reaction to the Polish crisis suggests that in times of trouble the most tempting way out of immediate difficulties is through the use of force. The open question is how long such a policy can succeed in maintaining the Soviet empire.